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Regulatory Pitfalls and Practicalities in Side-by-Side Management of Registered and Private Funds

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Side-by-side management of mutual funds and private funds has long been an area of regulatory focus as a poster child for potential and perceived conflicts of interest. This topic received renewed and concrete attention recently when, on November 8, 2018, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) published a Risk Alert announcing OCIE's risk-based examination initiatives of mutual funds, including exchange traded funds (ETFs) and their advisers.[1] Furthermore, in its announcement of 2019 examination priorities, OCIE specifically addressed advisers managing both mutual funds and private funds with similar investment strategies. As used by OCIE in the Risk Alert and in this article, "side-by-side" management refers to when an investment adviser manages mutual funds and private funds, "particularly when managed pursuant to similar strategies and/or by the same portfolio managers."[2] Side-by-side management provides vivid examples of conflicts central to our industry. This article focuses on recent developments in SEC oversight and enforcement related to side-by-side management practices, as well as practical considerations in responding to OCIE concerns in the current regulatory environment.

Historical Themes Related to Side-by-Side Management

The SEC historically has focused its attention on a discrete set of potential conflicts of interest common to side-by-side management given an investment adviser's fiduciary obligations across its clients.[3]

- *Varied fee structures*—Private funds often have fee structures, including carried interests or other performance-based compensation arrangements, that may incentivize a portfolio manager to favor a private fund over a mutual fund.
- *Adviser investments in mutual funds and private funds*—An adviser may make a substantial investment in a private fund it advises, in part in order to conform with investor expectations, which may result in a potential conflict of interest.
- *Trading practices*—Portfolio managers managing both a mutual fund and private fund engage in a variety of trading practices that may incentivize, or otherwise tend to result in, disparate treatment of the funds, with the mutual fund at risk of being disadvantaged.

- *Best execution*—The sequencing and execution of transactions can favor one client over another, giving rise to a conflict of interest.
- *Cross trades*—Given private funds' performance-based compensation arrangements, there is a concern that mutual funds may be disadvantaged in their participation in cross trades with private funds, despite the protections inherent in Rule 17a-7 under the Investment Company Act of 1940 (the 1940 Act).
- *Aggregation and allocation of trades*—The allocation of transactions among clients, when specific allocation decisions are intended to result in more favorable treatment for one client over another, has been the subject of SEC Staff scrutiny and SEC enforcement actions.
- *Brokerage commission allocations*—Soft-dollar arrangements may result in a mutual fund bearing an inequitable share of the cost of paying for research that benefits both the mutual fund and a private fund.

SEC focus on these conflicts of interest and their applicability to side-by-side management has developed over time. In 2003, as part of a broad review of hedge funds by the SEC, the SEC Staff identified similar themes in describing the unique nature of hedge fund fees and investment strategies within the scope of side-by-side management.[4] In 2010, Part 2 of Form ADV was amended to require side-by-side management disclosure, including an explanation of conflicts of interest and how the investment adviser addresses such conflicts, among other topics.[5] From 2014 until 2018, side-by-side management began to appear regularly in OCIE Risk Alerts.[6] Against this backdrop, there also has been a steady flow of applications from advisers seeking exemptive orders permitting side-by-side co-investments.[7]

When considering implications for today, it is helpful to review the history of enforcement actions related to these conflicts of interest themes.[8] The SEC has concluded several instructive enforcement actions against investment advisers relating to side-by-side management in the last year; deficient disclosure of conflicts of interest remains a popular area of focus, and "cherry-picking" schemes were the subject of a growing number of actions.[9] Ultimately, even with renewed SEC focus in this area, the substance of the deficiencies called out in enforcement actions has remained largely consistent with historical trends.[10]

Recent Regulatory Developments

Fiduciary standards underlie an investment adviser's responsibilities related to these potential conflicts of interest. The SEC proposed in April 2018, and adopted in June 2019, an interpretation to reaffirm and, in some cases, clarify the SEC Staff's views of the fiduciary duty that investment advisers owe to their clients.[11] This interpretation focused on adviser duties inextricably linked to side-by-side management conflicts of interest, reiterating the familiar two-pronged fiduciary standard that the "obligation to act in the best interest of its client is an overarching principle that encompasses both the duty of care and the duty of loyalty." The interpretation describes the duty of loyalty as requiring that an investment adviser must "eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested." While the interpretation does not focus explicitly on side-by-side management, it underscores the current broad, high-profile regulatory focus on the many related ways in which conflicts of interest manifest themselves in the relationship between investment advisers and their clients.

In addition, the OCIE has referenced side-by-side management in its Risk Alerts in three of the last five years,[12] focusing broadly on policies and procedures related to side-by-side management of performance-based and purely asset-based fee accounts. Going further in its November 2018 Risk Alert, OCIE explicitly detailed a review process for advisers advising both mutual funds and private funds with similar investment strategies or the same portfolio manager(s). Based on observations from prior

examinations, the SEC enumerated the following specific areas related to side-by-side management:

- Policies and procedures for addressing conflicts of interest and other risks associated with side-by-side management, particularly those related to certain portfolio management and portfolio construction practices;
- Controls for ensuring appropriate brokerage, best execution, and trade allocation practices, including trade aggregation and allocation of investment opportunities in a manner consistent with the adviser's fiduciary duty;
- Allocation practices for various fees and expenses; and
- Disclosures to investors and mutual funds' boards.

Practical Considerations

The historical framework and current regulatory trends outlined above provide useful context for advisers seeking to bolster their compliance oversight of side-by-side management and readiness for potential SEC Staff inquiries on the topic. Taking into account that the specific application to an individual advisory firm will depend heavily on the facts and circumstances, we devote the remainder of this article to reviewing several practical steps advisers can consider when mapping and refining their approach to identifying, disclosing, and mitigating the conflicts inherent in side-by-side management.

Compliance Policies and Procedures

In its November 2018 Risk Alert, the OCIE confirmed the SEC Staff generally would assess policies and procedures of the funds and their advisers, disclosures by the funds in filings and other shareholder communications and processes to assess controls in place under such policies. Undertaking a formal project to inventory and categorize these items would be a practical and productive response to the SEC's focus on side-by-side management. Many investment advisers have individual compliance policies tailored to various topics underlying side-by-side management. Policies related to best execution, trade allocation, and use of soft dollars, among other topics, are oftentimes distinct. One refinement that some managers have implemented is to develop a master policy overviewing side-by-side management implications, including a catalogue of these relevant underlying policies and any associated desktop procedures, which provides a helpful roadmap to OCIE examiners that hopefully minimizes potential confusion and preempts some of their follow-up questions. Such a master policy also can have the benefit of helping to ensure no gaps exist in coverage of related conflicts of interest risks. The exercise of reviewing and cataloguing also would provide an opportunity to promote better consistency across what can be a significant number of disparate policies.

Liquidity Risk Management Programs

The liquidity risk management program (LRMP) requirements pursuant to Rule 22e-4 under the 1940 Act went into full effect in 2019 and present a novel twist on the age-old challenges inherent in side-by-side management. LRMPs recently adopted under Rule 22e-4, requiring written policies and procedures for monitoring and managing liquidity risk, are mandatory only for mutual funds, including ETFs. Under these various LRMPs, every security in a mutual fund's portfolio is categorized based on its liquidity characteristics. These categorizations oftentimes are based on a diverse number of factors such as asset class, market depth, and the volume of assets pledged to satisfy margin requirements, among others. Liquidity monitoring under LRMPs dictates certain investment decisions in the event the volume of illiquid investments in a portfolio reaches certain thresholds. Portfolio managers should be aware of the impacts of a mutual fund's LRMP, particularly in instances where the

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allocation decisions vary between a private fund and the parallel mutual fund under the same portfolio management team due to constraints under the mutual fund's LRMP.

Ultimately, it may be prudent for an investment adviser to consider how its LRMP would apply to the private funds it manages, particularly in investment strategies similar to those of its mutual funds. There is merit in taking the liquidity program framework and considering a parallel structure applied to private funds in order to minimize the conflicts arising from inconsistent treatment of different clients. To the extent an investment adviser performs this analysis, it at least acknowledges the significant differences in liquidity profiles between the open-end mutual fund and private fund. At first blush, this type of level-setting with mutual fund LRMPs may seem like backdoor regulation of private funds through the artifices of a new operational rule under the 1940 Act, but it underscores the fiduciary predicament of advisers that balance client mandates across several contrasting regulatory regimes.

Conflicts of Interest Disclosure

A practical next step in addressing side-by-side concerns generally is to look at the range of disclosures that investment advisers have in place that touch on this topic. Given the structure of many investment advisory firms, these various disclosures often are developed and maintained by discrete groups within the larger organization. For instance, natural shifts over time can introduce daylight between the size, substance, and spirit of the disclosures in a fund's registration statement versus its investment adviser's Form ADV. Similarly, offering documents for private funds typically will reflect conflicts of interest, but from the perspective of the private fund investor. This exercise in reviewing and truing up different related disclosures across several formats is a critical step in minimizing the risks that arise from inconsistencies that inevitably creep in as documents are updated and businesses morph over time.

Generally, a mutual fund's registration statement disclosure should include sufficient detail to allow investors to appropriately evaluate potential conflicts of interest.[13] Item 20 of Form N-1A requires that a fund's statement of additional information include disclosure regarding any material conflicts of interest that may arise in connection with a portfolio manager's management of mutual fund investments and investments in other accounts. Similarly, advisers should review the requirements of Item 6 of the Part 2 brochure of their Form ADV, which introduces the topics of side-by-side management by dividing the world along the lines of performance-based fees and non-performance based fees. While the relevant Form ADV instructions emphasize this fee division, Item 6 provides an opportunity for the adviser to broaden its conflicts disclosure proactively in light of the recent regulatory developments outlined above.

When updating relevant conflicts of interest disclosure, it is important to note certain clarifications the SEC outlined in its June 2019 final interpretation entitled, "Commission Interpretation Regarding Standard of Conduct for Investment Advisers." Specifically, the Commission expressed its view that, as a general matter, the use of "may" is not adequate in a disclosure when a conflict of interest actually exists. Similarly, the SEC asserted that the use of "may" is inappropriate preceding a list of all potential or possible conflicts, regardless of likelihood. However, the SEC did confirm that "may" could be used appropriately to disclose a potential conflict that does not presently exist, but that could reasonably occur in the future.[14]

SEC Examinations

We are aware that the OCIE Staff has been conducting targeted examinations in which the side-by-side management themes in the OCIE Risk Alert have explicitly provided the framework for the Staff's in-depth reviews, interviews and follow-up requests. Anecdotally, we understand that the SEC Staff has highlighted the adviser's policies and practices as

to allocation of investment opportunities between mutual funds and private funds in these discussions. Portfolio managers have been asked to detail for the SEC Staff how decisions around allocation were made in order to minimize relevant conflicts of interest. Unsurprisingly the SEC Staff, in such examinations, has devoted considerable attention to reviewing related compliance policies, focusing on

Exhibit 1— Side-by-Side Management: Potential Portfolio Manager Discussion Topics

The table below is intended as a primer on side-by-side management questions that legal or compliance personnel might pose to portfolio managers managing an investment strategy for both a private and registered fund. For instance, these questions may be useful in preparing a portfolio manager for an interview with SEC examination Staff.

Topic: *Product Differentiation*

- What determines the strategies used by a private fund versus a mutual fund generally?
- How different are the private fund and mutual fund strategies? Are you applying exactly the same model?
- Do you make changes to the mutual fund and private fund portfolios in parallel? Is it lockstep or less formalized?
- Is there leverage on the private fund?

Topic: *Fees and Expenses*

- What are the fee structures of the mutual funds versus the private funds?
- Are there any performance fees or carried interest?
- Are any expenses allocated to the funds? How do those allocations differ between funds?
- How are brokerage expenses allocated between funds?
- Do trades generate soft dollars the same way for each fund?

Topic: *Potential Conflicts of Interest Situations*

- Is there any cross-trading between accounts?
- Are there any illiquid securities in the accounts? Have you ever had to hold onto securities you didn't want to keep because there was not a good price or a liquid market?
- Are there any hard-to-value assets in the portfolios? Are you (the portfolio manager) involved in pricing? Do you have the ability to override pricing decisions?
- Are you (the portfolio manager) involved in trading or does that go to a centralized desk?
- How are you (the portfolio manager) involved in best execution? Do you use brokers and have a broker vote process? How does process work? How is it documented?
- How do your trade rotation and trade allocation systems work?
- How do you approach allocation of investment opportunities? Are there instances where there is less liquidity or availability of an investment than what you are looking for?
- Do you participate in IPOs? Do you ever have limited IPO allocations that are smaller than your needs for accounts in the same strategy?

Topic: *Compliance Controls*

- How do you (the portfolio manager) interact with Compliance on trading and allocation questions?
- Has Compliance ever contacted you about conflicts between mutual funds and private funds?
- Have you had disagreements with Compliance over the permissibility of any actions?

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the breadth of coverage and associated procedures as well as systematic application and monitoring. In assessing its preparedness for such an SEC examination focus—or in preparing individual portfolio managers for an interview with the OCIE Staff—the legal and compliance departments of a registered adviser may benefit from conducting internal interviews in advance with portfolio managers managing an investment strategy subject to side-by-side management. To aid in such an exercise, we have outlined a high level primer of side-by-side management questions for portfolio managers in Exhibit 1.

While these tools may be helpful in preparation for the scrutiny of an SEC examination, ultimately the closer an investment adviser can get to a systematic approach to identifying and managing conflicts of interest related to side-by-side management, the better.

Conclusion

We expect SEC Examination Staff to pay particular attention to conflicts of interest disclosure and compliance policies in their review of investment advisers' side-by-side management practices. While the subject is not new, the SEC Staff has begun to target new themes in the breadth of potential conflicts of interest issues related to side-by-side management. In light of recent regulatory and enforcement action trends, several practical steps can significantly mitigate potential regulatory exposures and fiduciary concerns over conflicts of interest. An orderly review of compliance policies and procedures, in conjunction with a proactive approach to reconciling public disclosures and conducting preparatory interviews with relevant portfolio managers, will promote a robust framework in response to the increased attention from the SEC.

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NOTES

1 *See* Securities and Exchange Commission, Office of Compliance Inspections and Examinations, National Exam Program, Risk Alert: Risk-Based Examination Initiatives Focused on Registered Investment Companies (November 8, 2018), available at: *https://www.sec.gov/ocie/announcement/ocie-risk-alert-registered-investment-company-initiative*.

2 *Id.*

3 *See* Investment Company Institute, Side-by-Side Management of Registered Investment Companies and Investment Accounts (March 2004) and Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge Funds (September 2003).

4 *See* Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge Funds (September 2003).

5 *See* SEC Release No. IA-3060 (July 28, 2010).

6 *See* Securities and Exchange Commission, Office of Compliance Inspections and Examinations, National Exam Program, Risk Alert: Examination Priorities for 2014 (January 9, 2014), available at: *https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf*, Risk Alert: Examination Priorities for 2016, available at: *https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf* and Risk Alert for 2018 *supra* n.1.

7 *See* Carmen Germaine, "SEC Gives Side-By-Side Management the Side-Eye," *Ignites* (November 30, 2018).

8 *See, e.g.*, *Monetta Fin. Servs., Inc. v. S.E.C.*, 390 F.3d 952, 953 (7th Cir. 2004) (registered investment advisor failed to disclose to registered investment company clients allocation of shares of initial public offerings to individual advisory clients that included trustees and directors of the registered investment companies); *In re Zion Capital Management LLC, et al.*, SEC Initial Decision Rel. No. 220 (Jan. 29, 2003) (president and sole owner of a registered investment adviser favored an account in which he had a financial interest over one of the advisor's hedge

fund advisees, despite representations that any potential conflicts would be resolved fairly with respect to all interests); *Martin Currie Inc. and Martin Currie Investment Management Ltd.*, Advisers Act Rel. No. 3404 (May 10, 2002) (UK-based advisors used their US-registered mutual fund client to redeem a hedge fund client's exposure to a Chinese company while failing to make full and fair disclosure to the mutual fund's board of directors, resulting in a poor investment with low returns for the mutual fund); *In the Matter of Western Asset Management Co.*, Advisers Act Rel. No. 3762 (Jan. 27, 2014) (registered investment adviser arranged cross trading between advisee mutual funds and other client accounts, resulting in undisclosed favorable treatment of certain clients and violating Advisers Act section 206(2)); and *In the Matter of J.S. Oliver Capital Management, L.P. and Ian O. Mausner*, Advisers Act Rel. No. 4431 (Jun. 17, 2016) (registered investment adviser and its president and head portfolio manager engaged in fraudulent trade allocation by "cherry picking" favorable trades for hedge fund client accounts, in which the president was personally invested, to the detriment of other clients).

9 *See* Lisa Wood, *et al.*, "Securities and Exchange Commission Year in Review: Enforcement Actions and Issues from 2018" *The Investment Lawyer,* Vol. 26, No. 1 January 2019.

10 *See supra* n.8.

11 *See* SEC Release No. IA-4889 (April 18, 2018) and SEC Release No. IA-5248 (June 5, 2019).

12 *See supra* n.6.

13 *See* SEC Release No. IA-5248 (June 5, 2019).

14 *Id.*

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